SENATE HIGHWAYS AND TRANSPORTATION
EXHIBIT NO. 5
DATE: 1-13-2011
BILL NO. SB 137

NAMIC®
NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

HEADQUARTERS
3601 VINCENNES ROAD
INDIANAPOLIS, INDIANA 46268
TELEPHONE: (317) 875-5250
FAX: (317) 879-8408
WWW.NAMIC.ORG

WASHINGTON OFFICE
122 "C" STREET, NW
SUITE 540
WASHINGTON, D.C. 20001
TELEPHONE: (202) 628-1558
FAX: (202) 628-1601

January 12, 2011

Montana State Legislature
Senate Highways and Transportation Committee
PO BOX 200500
Helena, MT 59620-0500

sent via email to:
Rachel Weiss
Committee Staff, at
rweiss@mt.gov

Re: NAMIC's written comments in opposition to SB 137, Automobile Insurance Credit-Based Insurance Scoring Ban

**** Written comments are for committee members' consideration at hearing and need not be formally read into the hearing record. ****

Dear Senator Llew Jones, Chair, Senator Jon Sonju, Vice-Chair, and committee members:

Thank you for affording the National Association of Mutual Insurance Companies (NAMIC) an opportunity to submit written comments for the January 13, 2011, hearing on SB 137, Automobile Insurance Credit- Based Insurance Scoring Ban.

NAMIC is the largest and most diverse national property/casualty insurance trade and political advocacy association in the United States. Its 1,400 member companies write all lines of property/casualty insurance business and include small, single-state, regional, and national carriers accounting for 50 percent of the automobile/ homeowners market and 31 percent of the business insurance market. NAMIC has been advocating for a strong and vibrant insurance industry since its inception in 1895. NAMIC has 108 member insurance carriers doing business in the state of Montana, who write approximately 32% of the property/casualty insurance business in the state.

On behalf of NAMIC's members, I respectfully submit the following comments and concerns to the proposed amendments to Section 33-18-210, MCA:

1) **The use of Credit-Based Insurance Scoring benefits the majority of insurance consumers**

   In 2005, the Arkansas Department of Insurance began conducting an annual survey on the effect of the state's insurance scoring law on insurance consumers. Its 2008 survey concluded that of 3,033,996 personal lines policies written or renewed in that year, 41.9 percent of customers received a discount, 13.9 percent received an increase, and the remaining 45.1 percent of consumers saw a neutral impact due to insurer use of insurance scores.[1]

Additionally, the Federal Trade Commission's (FTC) 2007 study of insurers' use of credit scoring indicated that when credit scoring is used as an underwriting tool, 59% of consumers pay less for insurance versus 41% who pay more.

A 2006 study of the Oregon insurance market showed 58% of private auto policyholders paid lower premiums than they would have paid if insurance companies did not use credit information.[2]

A number of states have also recently looked at the impact credit-based insurance scoring has on consumer rates, and those studies have each shown that insurance consumers benefit from the use of this underwriting tool. Specifically, in Michigan, insurers reported in legal filings that a ban on insurers' use of credit would produce premium increases up to 68% for both auto and homeowner policies, with individual rates rising hundreds of dollars.[3]

Further, during the 2008 Wisconsin legislative session, a Wisconsin domestic company testified before the Wisconsin Senate that nearly 75% of their customers receive a discount because of the use of credit information. Similar testimony was provided to the Washington State Legislature in 2010, when proposed CBIS ban legislation was extensively debated and eventually defeated.

The statistical data throughout the country clearly supports the conclusion that credit-based insurance scoring is an underwriting tool that helps insurance carriers offer consumers a range of products and rates that work to the benefit of the majority of insurance consumers. There is no reason to believe that the impact of a CBIS ban in Montana would be beneficial to insurance consumers.

2) The proposed legislation will decrease market competition and limit consumer choice

The insurance underwriting process varies greatly between insurance companies, and is a comprehensive risk of loss exposure assessment that evaluates a large number of risk variables. Credit-based insurance scoring is just one of the many risk variables utilized by

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[1] Information about the annual credit scoring reports can be obtained by accessing the Arkansas Insurance Department website at: http://insurance.arkansas.gov/

[2] Oregon voters were asked to consider a statewide ballot initiative (Measure 42) in the November 2006 elections that would have banned insurer use of credit. The measure was defeated with citizens voting more than 2-1 (65.6% to 34.4%) against it, rejecting "mass subsidization." Study conducted by ECONorthwest in November 2006.

[3] In the case of Insurance Institute of Mich., et. al. v Commissioner of the Office of Financial and Insurance Services, (2005) Case #05-156-CZ, Barry County (MI) Circuit Court. There the Judge issued a clear and definitive opinion saying in part credit "clearly shows an actual effect on losses and expenses" (Judge's emphasis). The case is now on appeal (#262385).

insurers, who each weigh said insurance score differently, so that they can offer diverse and competitive rates, products, and services to the insurance consumer.

In today's competitive marketplace, insurance carriers use credit-based insurance scoring and other risk of loss assessment tools to improve the availability and affordability of insurance. The proposed credit-based insurance scoring ban would reduce the flexibility insurers currently have to offer a range of rating categories, price points, and product options for consumers.

Restricting how insurance carriers evaluate and rate insurance applicants will harm, not help insurance consumers, especially those consumers who benefit from being able to "shop the market" and take advantage of the different marketing strategies carriers are able to employ as a result of the existence of credit-based insurance scoring. If you limit underwriting tools, you ultimately limit consumer insurance options.

3) Insurance consumers need and desire insurance rates that accurately reflect their personal risk of loss exposure

In November of 2006, 65.58% of Oregon's voters voted to oppose Ballot Measure 42, which would have banned the use of credit-based insurance scoring.

Moreover, in recent years, a number of state legislatures have considered the idea of banning the outright use of credit-based insurance scoring, but not a single state during this time has enacted legislation that effectuates such a prohibition.

Once consumers and legislators are educated about how credit-based insurance scoring actually works, how it is different from credit scoring used by the financial lending industry, and the vast array of rating benefits derived from the use of this risk of loss exposure assessment tool, the ranks of detractors of credit-based insurance scoring markedly dwindle, and these bills end up dead in committee.

4) Federal agencies and state Departments of Insurance studies have consistently found that Credit-Based Insurance Scoring is a fair, equitable, and appropriate predictor of a consumer's claims potential, the very essence of insurance

The list of state and federal agencies that have studied the correlation between a consumer's credit-based insurance score and the frequency and severity of the consumer's claims history is impressive. These studies have repeatedly reported that a consumer's credit-based insurance score provides insurers with valuable information that assists insurers in predicting a consumer's claims potential.

In fact, a 2004-2005 study by the Texas Department of Insurance found that *"credit is a better predictor of claims than most other rating factors . . . ."*

According to the FTC's own July 24, 2007, press release on their study of credit-based insurance scoring, the FTC study concluded that "[credit-based insurance] scores effectively predict the number of claims consumers file and the total cost of those claims. Their use is likely to make the price of insurance better match the risk of loss that consumers pose. Thus, on average, as a result of the use of scores, higher-risk consumers pay higher premiums and lower-risk consumers pay lower premiums."

5) **A complete ban on the use of Credit-Based Insurance Scoring is unnecessary and inconsistent with the national trend on the regulation of this underwriting tool**

The National Conference of Insurance Legislators (NCOIL) has studied and debated the issue of whether credit-based insurance scoring is a reasonable and appropriate underwriting tool for many years now, and this learned counsel of experienced insurance legislators from the four-corners of this country have consistently concluded that regulation not prohibition of the use of credit-based insurance scoring is best for the insurance consumer. Specifically, 90 bills have been introduced in 27 states since the beginning of the biennium in 2009, but not a single CBIS ban bill has been passed by a state legislature.

Twenty-seven (27) states, including Montana, have enacted some version of the NCOIL "Model Act Regarding the Use of Credit Information in Personal Insurance", and forty-seven (47) states have enacted legislation regulating the use of credit-based insurance scoring. The overwhelming national tend is to regulate the use of this valuable underwriting tool, so that it takes into account extraordinary life circumstance that may adversely impact a consumer's credit-based insurance score. In essence, SB 137 would "throw the baby out with the bath water." Such a drastic response is unnecessary and unwise.

6) **Consumers already have legal and regulatory protections against unfair discrimination**

The "Montana Use of Credit Information in Personal Insurance Act" sets forth, in Section 33-18-605, MCA, very specific provisions as to when and how consumer credit information may be used by an insurer in their rate setting and underwriting process.

Additionally, the Fair Credit Reporting Act (FCRA) provides consumers with ample protection against unlawful discrimination by insurers in their use of credit-based insurance scores. Thus, from a consumer protection standpoint, SB 137 is really unnecessary.

In closing, NAMIC respectfully requests that the Senate Highways and Transportation Committee **"VOTE NO" on SB 137**, so that insurance consumers in the state of Montana will be able to continue to enjoy the benefits of price competition that has resulted from the use credit-based insurance scoring by the insurance industry.

Thank you for your time and consideration. Please feel free to contact me at 303.907.0587 or at crataj@namic.org, if you have any questions about NAMIC's written comments. I have also attached a copy of NAMIC's Issue Brief on CBIS, "Credit-Based Insurance Scoring: Separating Facts from Fallacies" (Published: 2/22/2010) for your reference.

Respectfully,

Christian John Rataj, Esq.
NAMIC Western State Affairs Manager

NAMIC Policy Briefing

Credit-Based Insurance Scoring: Separating Facts From Fallacies

Introduction

Credit-based insurance scores have been used by insurance company underwriters and actuaries for nearly two decades to more accurately assess risk and price coverage for automobile and homeowners' insurance policies.

The use of insurance scores encourages competition and enables insurers to offer coverage to more consumers at a fairer price. Furthermore, consumers benefit from insurance scoring because it keeps the insurance marketplace competitive, resulting in lower prices, better service, and more product choices. Insurance scores provide an objective, fair, and consistent tool that insurers use with other information to better predict the likelihood of future claims and the cost of those claims.

During the 1990s, lawmakers and regulators in several states began enacting laws and regulations that established procedures for insurers to follow in using an individual's credit information. In 2002, the National Conference of Insurance Legislators (NCOIL) created a "Model Act Regarding Use of Credit Information in Personal Insurance," which became the basis for additional legislation in other states. Today, 47 states have laws or regulations pertaining to credit-based insurance scoring.[1]

In spite of an apparent consensus on this issue, some public officials and advocacy groups have continued to press for further restrictions on the use of insurance scores, or to prohibit the practice entirely.

This *Policy Briefing* provides a review of the evolution of credit-based insurance scoring, the laws governing its practice, some misconceptions about insurance scoring, and studies that have examined the impact of insurance scoring on consumers. It is intended to educate legislators and other policymakers who may be unfamiliar with insurance scoring and its utility as a predictive tool that benefits insurers and consumers alike.

Credit Scores and Insurance Scores: An Important Distinction

Insurance scores are not credit scores. Credit scores predict the likelihood that an individual will default or be delinquent in paying a credit obligation. By contrast, a credit-based insurance score predicts the likely "loss ratio relativity" of a particular individual. A loss ratio is the amount paid out by an insurance company in claims divided by the amount collected in premiums. Loss ratio relativity measures whether an individual will experience more or fewer losses than average.[2]

Another important distinction between a credit score and a credit-based insurance score is that the latter is only one of more than two dozen factors that are used by insurers to make an underwriting or rating decision about an individual. Other factors typically include an individual's motor vehicle report, claims history, or the condition of one's home.

The NCOIL Model

As noted above, NCOIL adopted a model law in 2002 (updated in 2005) that imposes conditions on insurers' use of credit information in personal insurance transactions. Twenty-six states have adopted the model while other states have adopted at least portions of the model in their statutes.[3]

The model imposes at least eight specific restrictions on how insurers use credit information in underwriting or rating risks. For example, the model prohibits insurers from using an insurance score that is calculated

Headquarters
3601 Vincennes Road
Indianapolis, IN 46268
317.875.5250
Fax: 317.879.8408

Washington Office
122 C Street, N.W.
Suite 540
Washington, D.C. 20001
202.628.1558
Fax: 202.628.1601

www.namic.org

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using income, gender, address, zip code, race, ethnicity, religion, marital status, or an individual's nationality.

The model also prohibits an insurer from denying, canceling or non-renewing a personal insurance policy solely on the basis of credit information. An insurer cannot deny insurance coverage solely on the grounds that the consumer does not have a credit account.

The model outlines a process for insurers to follow if they raise a policyholder's premium or decline to renew coverage based on credit information. Other provisions lay out procedures that a consumer can follow in challenging a credit report or in challenging an adverse action taken against them by an insurer.

In response to the economic crisis, NCOIL amended its model in July 2009 by moving the extraordinary life circumstances (ELC) drafting note into the body of the model and broadening its provisions. The amendment states, in part, that upon written request from an applicant for insurance or an insured, an insurer that utilizes credit information as part of its underwriting process shall "provide reasonable exceptions to the insured's rates, rating classifications, company or tier placement, or underwriting rules or guidelines for a consumer who has experienced and whose credit information has been directly influenced by events deemed to be ELC." This would include federal or state-declared catastrophes; serious illness or injury to a consumer or his/her immediate family; death of a spouse, child, or parent; divorce or involuntary interruption of legally owed alimony or support payments; identity theft; temporary and involuntary loss of employment for three months or more; and military deployment overseas, among other items.

Insurance Scoring Misconceptions

The issue of credit-based insurance scoring can lead to emotional debate among competing interest groups, which can often result in several misconceptions about how insurers use insurance scores. As a general matter, such misconceptions lose sight of the fact that insurance is a competitive business, and insurers use insurance scores because they want to offer products to more individuals at the lowest price possible. Some critics have argued that credit-based insurance scoring should be prohibited because it unfairly discriminates against minorities. This is a specious claim because insurance scoring does not consider characteristics such as race, ethnicity, gender, national origin, or income level.

Every empirical study has concluded that insurance scoring is neutral on its face with respect to race, ethnicity, and income, and is applied neutrally by insurers. The use of insurance scoring is not motivated by a desire to discriminate based on race, ethnicity, or income nor do insurers collect or use this information. Nevertheless, some critics contend that even if the correlation between credit scores and loss history is statistically

Insurance Scoring and the Financial Crisis

In some recent published reports, critics of insurance scoring have suggested that the practice is particularly problematic due to the current economic crisis. However, this contention is based on unproven assumptions and a lack of understanding regarding why insurers use credit-based insurance scores. In fact, this underwriting tool remains an effective and important risk assessment mechanism.

Scores have remained very stable
Fair Isaac, a leading provider of credit-based insurance scores, found in a recent countrywide study that average scores have remained virtually the same for the general population. Noting the significance of this finding during an economic downturn with a growing number of people who are delinquent, Fair Isaac suggests that the "overall stability of scores may be caused by a greater number of consumers making certain to pay all bills on time, paying down outstanding balances, and perhaps not seeking more credit obligations." In other words, "more and more consumers appear to be realizing the value of prudent financial and credit management practices."

Not all credit-related incidents will affect insurance underwriting and rating
It is undeniable that a growing number of consumers are experiencing credit-related incidents such as loan defaults and foreclosures, but it is important not to make assumptions or generalizations about the impact of such incidents on insurance underwriting and rating. Some individuals who experience such incidents may not see an impact because they previously had credit issues that were already reflected in scores. And it is important to remember that insurers use scores in a variety of ways to differentiate applicants and insureds on a relative basis in terms of insurance risk, not credit risk, to compete for and price business appropriately. Fair Isaac found in its most recent score performance studies that its insurance scores "continue to appropriately rank-order consumers based on insurance risk." Even if credit scores were to deteriorate in general, those with the higher insurance scores would still benefit, and there is no reason to expect that the percentages of those who benefit would change.

The financial crisis demonstrates the importance of risk assessment
While there has been much discussion over assignment of blame for the current economic crisis, it is apparent that it is rooted in a failure to properly assess risk. It is only due to insurers' recognition of credit-based insurance scoring as a highly valuable risk assessment tool that it has become a common practice. It would be both ironic and inappropriate for a financial crisis caused by failure to assess risk to prompt policymakers to take a valuable risk assessment tool out of the hands of insurers.

valid, insurance scoring should be banned if it produces a disproportionate or disparate impact on particular racial, ethnic, or income groups.

"Disparate impact" is a legal term that refers to situations in which a policy or practice has the effect of disproportionately harming or excluding members of a group defined by race, ethnicity, disability, or gender—even though the challenged practice makes no reference to these characteristics and even though the resulting adverse group impact was unintentional.

Disparate *treatment*, on the other hand, refers to situations in which a decision-maker intentionally discriminates against people *because of* their race, ethnicity, disability, or gender. Intentional discrimination based on such characteristics is what most people think of when they hear the term unfair discrimination, and it is generally illegal under federal and state law.

Credit-based insurance scoring does not involve disparate treatment of customers based on race, ethnicity, income, or any other legally prohibited characteristic. To the contrary, insurers apply the same credit standards to all consumers—in other words, insurance scoring is a means of affording equal treatment in the underwriting process to all individuals regardless of race, ethnicity, or income. Policymakers should consider which form of discrimination is truly unfair—disparate impact on groups or disparate treatment of individuals.

Even if one is inclined to accept the notion that disparate impact somehow equates to unfair discrimination, it is important to note that as used in the courts, a showing of disparate impact serves only to establish a *rebuttable presumption* that illegal discrimination has occurred. Moreover, courts have generally confined use of the disparate impact theory to cases involving allegations of employment discrimination. In employment cases, defendants may rebut the presumption of unfair discrimination by demonstrating that the practice having a disparate impact is justified by "business necessity."

In the few instances where disparate impact analysis has been applied to settings similar to insurance underwriting and pricing—e.g., mortgage lending and the granting of credit—the courts have upheld challenged practices where defendants have shown a "legitimate business justification" for the practice. Because of its proven validity as an underwriting variable, it is undeniable that insurers have a legitimate business justification for using credit-based insurance scores.

Furthermore, insurer use of insurance scores is subject to the protections of the Fair Credit Reporting Act, federal and state anti-discrimination laws, and state insurance rating laws. These laws prohibit insurers from discriminating on the basis of race, religion, or national origin and include strong penalties for any violations.

Another popular misconception is that an individual's insurance score will be affected if too many requests are made to examine the individual's credit information. This is not an issue in states that have adopted the NCOIL model, as it expressly prohibits insurers from treating as a negative factor credit inquiries not initiated by the consumer or inquiries requested by consumers to examine their own credit information.

Research and Reports on Credit-Based Insurance Scoring

Since 1999, at least a dozen studies have examined credit-based insurance scoring. They have tended to fall into two broad categories: those studies that have looked at the predictability of insurance scores on loss performance or insurance risk and those that have examined the impact of insurance scoring on consumers, especially minority or low-income populations.

Among the studies worth noting are three that employed multivariate analysis techniques. In 2003, EPIC Actuaries, in the largest and most comprehensive study ever undertaken at the time, found that a consumer's credit-based insurance score is directly connected to that consumers' propensity for auto insurance loss. Even more significant, the EPIC study found that insurance scores are consistently among the most important rating variables used by insurers. The EPIC study looked at 2.7 million automobile insurance policies and found that the propensity for loss decreased as the insurance score increased.[4]

In 2005, the Texas Department of Insurance (TDI) completed an exhaustive study based on data obtained from six leading insurers for approximately two million automobile and homeowners' policies. The TDI report concluded that "for both personal auto liability and homeowners, credit score was related to claim experience even after considering other commonly used rating variables. *This means that credit score provides insurers with additional predictive information distinct from other rating variables. By using credit scores, insurers can better classify and rate risks based on differences in claims experience.*"[5] In July 2007, the Federal Trade Commission (FTC) released a study that reached conclusions virtually identical to those of the TDI report. It also found that when credit-based insurance scoring is used, 59 percent of consumers pay less for insurance.[6]

In 2005, the Arkansas Department of Insurance began conducting an annual survey on the effect of the state's insurance scoring law on insurance consumers. Its 2008 survey concluded that of 3,033,996 personal lines policies written or renewed in that year, 41.9 percent of customers received a discount, 13.9 percent received an increase, and the remaining 45.1 percent of consumers saw a neutral impact due to insurer use of insurance scores.

In 2009, the Consumer Advocate for the Iowa Department of Insurance commissioned researchers from St. Ambrose University to survey Iowa consumer attitudes toward credit-based insurance scoring. Seventy-one percent of Iowans felt that credit scores should not be used to determine insurance rates, but fewer than 30 percent understood why insurers use credit scores. The report found that Iowans' "opinions seem to be based on widely-held, but incorrect, perceptions that credit scores are not predictive of risky behavior that might lead to a tendency to file claims."[81] More generally, the report noted that "consumers are seriously uninformed about insurance fundamentals. Iowa consumers do not have a clear notion of what it means to spread the risk."[92] The report suggested that to enhance public understanding, "the legislature might include a block of instruction at the high school level on both insurance and the wide-ranging effects of credit scores."[10]

Conclusion

Effective underwriting allows insurers to operate profitably and to compete in the marketplace. Likewise, appropriate underwriting ensures that consumers benefit by not subsidizing other policyholders who pose worse insurance risks, resulting in unfair cross-subsidization among risk classes.

Banning or limiting the use of any valid underwriting or rating factor that is known to be predictive of insurance losses leads to decreased coverage availability and higher insurance prices. A legislator or regulator considering a prohibition on the use of credit-based insurance scoring should be prepared to explain to constituents, including those of every ethnic background and income level, why he or she decided they should pay more for insurance.

Experience has shown time and again how limitations on insurers' use of proven risk factors such as geography and age of driver have destroyed competitive markets and increased prices. A ban on the use of credit-based insurance scores would be counterproductive and would harm, rather than benefit, consumers.

Endnotes

[1]The National Association of Mutual Insurance Companies has compiled a chart showing the actions taken in various states with regard to credit-based insurance scoring. The chart can be found at www.namic.org/compliance/ CreditBasedInsuranceScoring.pdf

[2]The Fair Isaac website (www.fairisaac.com/ficx/) provides an excellent explanation of how credit risk and credit-based insurance scoring models work.

[3]A copy of the NCOIL Model Act Regarding Use of Credit Information in Personal Insurance can be ordered at the NCOIL website (www.ncoil.org/).

[4]Michael J. Miller and Richard A. Smith, "The Relationship of Credit-Based Insurance Scores to Private Passenger Automobile Insurance Loss Propensity: An Actuarial Study (June 2003). www.ask-epic.com/Publications/Relationship%20of%20 Credit%20 Scores_062003.pdf

[5] "Supplemental Report to the 79th Legislature: Use of Credit Information by Insurers in Texas: The Multivariate Analysis," Texas Department of Insurance (Jan. 31, 2005), p. 2. (Emphasis added.)

[6]Federal Trade Commission, "Credit-Based Insurance Scores: Impacts on Consumers of Automobile Insurance," (July 2007). www.ftc.gov/os/2007/07/P044804FACTA_Report_Credit-Based_Insurance_Scores.pdf

[7]Information about the annual credit scoring reports can be obtained by accessing the Arkansas Insurance Department website at: http://insurance.arkansas.gov/

[8]Randy L. Richards et al., *Use of Credit Scores by the Insurance Industry: Iowa Consumers' Perspectives*, St. Ambrose University, December 2009, p. 31.

[9]*Ibid*, p. 32.

[10]*Ibid*

NAMIC Policy Briefing

Headquarters
3601 Vincennes Road
Indianapolis, IN 46268
317.875.5250
Fax: 317.879.8408

Washington Office
122 C Street, N.W.
Suite 540
Washington, D.C. 20001
202.628.1558
Fax: 202.628.1601

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The issue of credit-based insurance scoring can lead to emotional debate among competing interest groups, which can often result in several misconceptions about how insurers use insurance scores. As a general matter, such misconceptions lose sight of the fact that insurance is a competitive business, and insurers use insurance scores because they want to offer products to more individuals at the lowest price possible. Some critics have argued that credit-based insurance scoring should be prohibited because it unfairly discriminates against minorities. This is a specious claim because insurance scoring does not consider characteristics such as race, ethnicity, gender, national origin, or income level.

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Not all credit-related incidents will affect insurance underwriting and rating

It is undeniable that a growing number of consumers are experiencing credit-related incidents such as loan defaults and foreclosures, but it is important not to make assumptions or generalizations about the impact of such incidents on insurance underwriting and rating. Some individuals who experience such incidents may not see an impact because they previously had credit issues that were already reflected in scores. And it is important to remember that insurers use scores in a variety of ways to differentiate applicants and insureds on a relative basis in terms of insurance risk, not credit risk, to compete for and price business appropriately. Fair Isaac found in its most recent score performance studies that its insurance scores "continue to appropriately rank-order consumers based on insurance risk." Even if credit scores were to deteriorate in general, those with the higher insurance scores would still benefit, and there is no reason to expect that the percentages of those who benefit would change.

The financial crisis demonstrates the importance of risk assessment

While there has been much discussion over assignment of blame for the current economic crisis, it is apparent that it is rooted in a failure to properly assess risk. It is only due to insurers' recognition of credit-based insurance scoring as a highly valuable risk assessment tool that it has become a common practice. It would be both ironic and inappropriate for a financial crisis caused by failure to assess risk to prompt policymakers to take a valuable risk assessment tool out of the hands of insurers.

valid, insurance scoring should be banned if it produces a disproportionate or disparate impact on particular racial, ethnic, or income groups.

"Disparate impact" is a legal term that refers to situations in which a policy or practice has the effect of disproportionately harming or excluding members of a group defined by race, ethnicity, disability, or gender—even though the challenged practice makes no reference to these characteristics and even though the resulting adverse group impact was unintentional.

Disparate *treatment*, on the other hand, refers to situations in which a decision-maker intentionally discriminates against people *because of* their race, ethnicity, disability, or gender. Intentional discrimination based on such characteristics is what most people think of when they hear the term unfair discrimination, and it is generally illegal under federal and state law.

Credit-based insurance scoring does not involve disparate treatment of customers based on race, ethnicity, income, or any other legally prohibited characteristic. To the contrary, insurers apply the same credit standards to all consumers—in other words, insurance scoring is a means of affording equal treatment in the underwriting process to all individuals regardless of race, ethnicity, or income. Policymakers should consider which form of discrimination is truly unfair—disparate impact on groups or disparate treatment of individuals.

Even if one is inclined to accept the notion that disparate impact somehow equates to unfair discrimination, it is important to note that as used in the courts, a showing of disparate impact serves only to establish a *rebuttable presumption* that illegal discrimination has occurred. Moreover, courts have generally confined use of the disparate impact theory to cases involving allegations of employment discrimination. In employment cases, defendants may rebut the presumption of unfair discrimination by demonstrating that the practice having a disparate impact is justified by "business necessity."

In the few instances where disparate impact analysis has been applied to settings similar to insurance underwriting and pricing—e.g., mortgage lending and the granting of credit—the courts have upheld challenged practices where defendants have shown a "legitimate business justification" for the practice. Because of its proven validity as an underwriting variable, it is undeniable that insurers have a legitimate business justification for using credit-based insurance scores.

Furthermore, insurer use of insurance scores is subject to the protections of the Fair Credit Reporting Act, federal and state anti-discrimination laws, and state insurance rating laws. These laws prohibit insurers from discriminating on the basis of race, religion, or national origin and include strong penalties for any violations.

Another popular misconception is that an individual's insurance score will be affected if too many requests are made to examine the individual's credit information. This is not an issue in states that have adopted the NCOIL model, as it expressly prohibits insurers from treating as a negative factor credit inquiries not initiated by the consumer or inquiries requested by consumers to examine their own credit information.

Research and Reports on Credit-Based Insurance Scoring

Since 1999, at least a dozen studies have examined credit-based insurance scoring. They have tended to fall into two broad categories: those studies that have looked at the predictability of insurance scores on loss performance or insurance risk and those that have examined the impact of insurance scoring on consumers, especially minority or low-income populations.

Among the studies worth noting are three that employed multivariate analysis techniques. In 2003, EPIC Actuaries, in the largest and most comprehensive study ever undertaken at the time, found that a consumer's credit-based insurance score is directly connected to that consumers' propensity for auto insurance loss. Even more significant, the EPIC study found that insurance scores are consistently among the most important rating variables used by insurers. The EPIC study looked at 2.7 million automobile insurance policies and found that the propensity for loss decreased as the insurance score increased.[4]

In 2005, the Texas Department of Insurance (TDI) completed an exhaustive study based on data obtained from six leading insurers for approximately two million automobile and homeowners' policies. The TDI report concluded that "for both personal auto liability and homeowners, credit score was related to claim experience even after considering other commonly used rating variables. *This means that credit score provides insurers with additional predictive information distinct from other rating variables. By using credit scores, insurers can better classify and rate risks based on differences in claims experience*."[5] In July 2007, the Federal Trade Commission (FTC) released a study that reached conclusions virtually identical to those of the TDI report. It also found that when credit-based insurance scoring is used, 59 percent of consumers pay less for insurance.[6]

In 2005, the Arkansas Department of Insurance began conducting an annual survey on the effect of the state's insurance scoring law on insurance consumers. Its 2008 survey concluded that of 3,033,996 personal lines policies written or renewed in that year, 41.9 percent of customers received a discount, 13.9 percent received an increase, and the remaining 45.1 percent of consumers saw a neutral impact due to insurer use of insurance scores.

In 2009, the Consumer Advocate for the Iowa Department of Insurance commissioned researchers from St. Ambrose University to survey Iowa consumer attitudes toward credit-based insurance scoring. Seventy-one percent of Iowans felt that credit scores should not be used to determine insurance rates, but fewer than 30 percent understood why insurers use credit scores. The report found that Iowans' "opinions seem to be based on widely-held, but incorrect, perceptions that credit scores are not predictive of risky behavior that might lead to a tendency to file claims."[8] More generally, the report noted that "consumers are seriously uninformed about insurance fundamentals. Iowa consumers do not have a clear notion of what it means to spread the risk."[9] The report suggested that to enhance public understanding, "the legislature might include a block of instruction at the high school level on both insurance and the wide-ranging effects of credit scores."[10]

Conclusion

Effective underwriting allows insurers to operate profitably and to compete in the marketplace. Likewise, appropriate underwriting ensures that consumers benefit by not subsidizing other policyholders who pose worse insurance risks, resulting in unfair cross-subsidization among risk classes.

Banning or limiting the use of any valid underwriting or rating factor that is known to be predictive of insurance losses leads to decreased coverage availability and higher insurance prices. A legislator or regulator considering a prohibition on the use of credit-based insurance scoring should be prepared to explain to constituents, including those of every ethnic background and income level, why he or she decided they should pay more for insurance.

Experience has shown time and again how limitations on insurers' use of proven risk factors such as geography and age of driver have destroyed competitive markets and increased prices. A ban on the use of credit-based insurance scores would be counterproductive and would harm, rather than benefit, consumers.

Endnotes

[1] The National Association of Mutual Insurance Companies has compiled a chart showing the actions taken in various states with regard to credit-based insurance scoring. The chart can be found at www.namic.org/compliance/ CreditBasedInsuranceScoring.pdf

[2] The Fair Isaac website (www.fairisaac.com/ficx/) provides an excellent explanation of how credit risk and credit-based insurance scoring models work.

[3] A copy of the NCOIL Model Act Regarding Use of Credit Information in Personal Insurance can be ordered at the NCOIL website (www.ncoil.org/).

[4] Michael J. Miller and Richard A. Smith, "The Relationship of Credit-Based Insurance Scores to Private Passenger Automobile Insurance Loss Propensity: An Actuarial Study (June 2003). www.ask-epic.com/Publications/Relationship%20of%20 Credit%20 Scores_062003.pdf

[5] "Supplemental Report to the 79th Legislature: Use of Credit Information by Insurers in Texas: The Multivariate Analysis," Texas Department of Insurance (Jan. 31, 2005), p. 2. (Emphasis added.)

[6] Federal Trade Commission, "Credit-Based Insurance Scores: Impacts on Consumers of Automobile Insurance," (July 2007). www.ftc.gov/os/2007/07/P044804FACTA_Report_Credit-Based_Insurance_Scores.pdf

[7] Information about the annual credit scoring reports can be obtained by accessing the Arkansas Insurance Department website at: http://insurance.arkansas.gov/

[8] Randy L. Richards et al., *Use of Credit Scores by the Insurance Industry: Iowa Consumers' Perspectives*, St. Ambrose University, December 2009, p. 31.

[9] *Ibid*, p. 32.

[10] *Ibid*